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Rosefinch Weekly

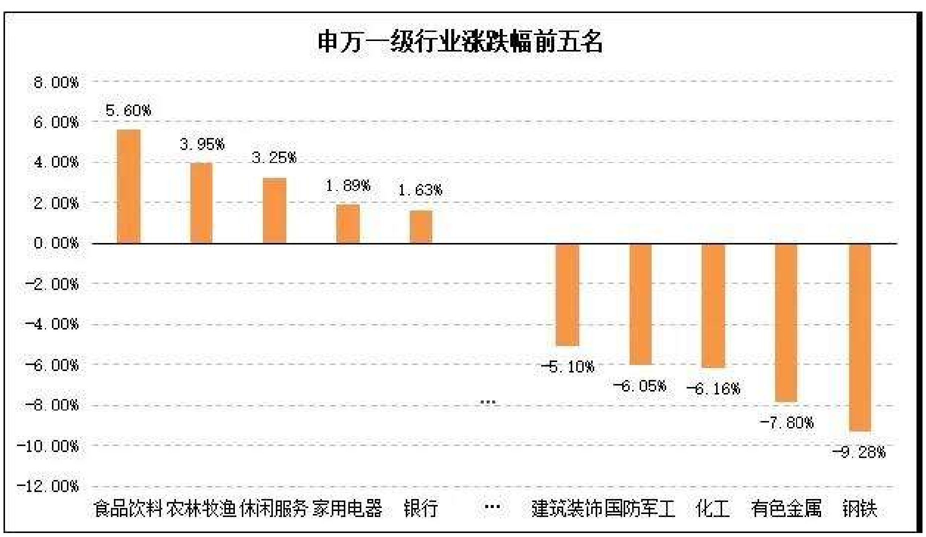
A-share: structural opportunities to lead slow bull market

1. Market Review

China is back from the Oct 1st to 7th National Day holiday week. For the previous week, A-share market indices had varied performance: SSE was -1.24%, SZI was -0.34%, GEM was +1.15%, SSE50 was +1.65%, CSI300 was +0.35%, and CSI500 was -3.75%.

Source: Wind, Rosefinch.

Amongst the ShenWan Primary industries, 7 out of 28 rose with food & beverages, agricultural, leisure service, home appliance, and banks the top 5 performers.



Source: Wind, Rosefinch

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Market volume decreased ahead of the holiday week, with daily volume on Sep 30th falling under 1 trillion RMB for the first time after 49 consecutive trillion-RMB volume days. Northbound net +6.97 billion RMB, and Southbound net +8.57 billion HKD.

Source: Wind, Rosefinch. Blue is cumulative Northbound flow; yellow is cumulative Southbound flow; unit is in 100 million RMB.

2. Market Outlook

China's Sep manufacturing PMI was 49.6 or just below the key 50 line, continuing its downward trajectory since March 2021. In a normal year, Sep manufacturing PMI should be higher than August number since it's high order season for year end holidays. This year there was a drop of 0.5 from August due to the tightening government control both in peak and in total energy consumption, which severely limited industrial capacity especially when they were ramping up for holiday season productions. In addition, real estate investment and consumption were relatively weak, leading to noticeable impacts to downstream demands. The overall economic trend remains one of weakening, at least for now.

While there are increased reports of government policy impacts on real estate sector and affiliated financial sector, the overall policy remains one of cautious framework with strict stance against speculative home purchases. On the margin though, in order to maintain the overall long term healthy development of the real estate market, there is a slightly softening tone. Recently there's media report of issuances of all remaining 2021 local government special bonds in Oct and Nov, with no quota left in Dec. The current remaining quota is around 1.5 trillion RMB, or roughly 700 to 800 billion RMB for both Oct and Nov. Since the total issuance of local government special bonds in first 9 months of the

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year was about 2.1 trillion RMB or roughly 230 billion RMB per month, this increase to 700 or 800 billion RMB a month will have some impact to market liquidity. PBOC has repeatedly commented that it will coordinate closely with other government agencies to offset the financial market impact of such special bond issuances, so we do not expect any sizeable or lasting impact to the market.

China is entering in a new phase of development that promotes new developmental concept and framework, with priority on high quality development. There are two major perspectives on high quality development: technological innovation and common prosperity. Government policy responses have also shifted as the focuses are now implementation of the 14th five-year plan; progressing towards 2035 strategic goals; and manage well the balance between improved efficiency and social fairness. **The traditional industries are consolidating further; capital market is leaning towards new economy; and A-share's cyclicality is decreasing and becoming less correlated with macro monetary supply. The equity market's slow bull theme will be led and pushed by structural opportunities, with caution towards global risks, especially that of large volatile moves in the US market.**

As economic growth slows, more industries are shifting from production expansion to inventory management mode as industry chain fights for reallocation of profits. Those market leaders with steady production capacity will gain strategic advantages, and those with key technologies or supply-chain chokeholds will gain pricing power. The recent energy control that capped electricity utilization and production magnified the profit reallocation effects. It's worth noting that the capping of peak and total energy consumption has been in place since the previous five-year plan. This year, some local provinces didn't meet the targets in the 1st half and tried to "catch up" by aggressively enforcing the policy. At the same time, there was a shortage in electricity supply due to both reduction in renewable energy generation and the coal-shortage for fire generation that account for ¾ of China's total energy production. This shortage in electricity supply has a clear impact as industrial production slowed, PMI dipped, and PPI rose on back of higher industrial material costs. While government cautioned against overzealous carbon-reduction tactics back in July, it took wide-ranged rolling blackouts in residential areas for people to notice the problem. The priority is now shifting back to stable supply and steady electricity prices. When dealing with the energy shortage situation, most local responses include manage expectations, allow higher electricity pricing, increase coal mine production, rebalance inter-regional electricity grids. The long-term solution in coal shortage lies in increasing local production capacity as well as foreign supplies. Right now, we already see increasing material costs squeezing mid- to down-stream enterprises, thus reducing industrial demands, which in turn will affect employment, social income, and consumptions.

The week before Oct 1-7 holiday was volatile with an overall cautious tone. US market was hampered by debt ceiling worries and stagflation concerns. A-share had wide dispersion with market shifting from small- and mid-cap to large cap. SSE50 and CSI300 benefited from higher food & beverage sector, while the more cyclical CSI500/1000 and dividend indices all dropped as cyclical sectors like nonferrous metal, steel, coal, chemical and construction all dropped. The dispersion between lower cyclical stocks and higher commodity prices is interesting: commodity rose due to supply and demand imbalance and front-

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end contracts' upward momentum; cyclical stocks are more subject to future profit expectations and room for appreciation. As government highlighted using market force to deal with commodity price rallies, various agencies began working together to improve supply, stabilize price, and anchor future price expectations. The price hike expectations from supply shock will come and go quickly, and we should see in 4Q21 marginal improvements in commodity supply and slower price increases. The consumer sector is still facing relatively weak fundamentals. While there's some bottom-picking flows with consumer stables rallying, the clear upward trend will still need to wait for consumption recovery.